

September 24, 2003

Dear Ben:

Thank you for your interest regarding the proposed changes to the Federal oil valuation rule. As a follow-up to your September 2, 2003, meeting with the Associate Director, Minerals Revenue Management (MRM), you asked the following questions and I would like to provide a response to each of them.

1. Why is MMS proposing to allow a rate of return on capital investment of 1.5 times BBB Standard and Poor's Bond Rate when Mr. Chavet believes that this is greater than the rate that FERC allows industry?

In regards to your question, we have accessed FERC's website at www.ferc.gov and printed some information which you may find helpful. Copies are enclosed for your convenience. For further information contact Mr. Larcamp at FERC. His number is 202-502-6700.

2. Why did MMS assume in its calculations that oil pipeline losses in non-arm's-length transactions are 0.2 percent of the volume of the production?

The 0.2 percent figure comes from MMS's experience with transportation allowances and examples from oil tariffs. Although the percentages of oil pipeline losses do vary, we chose to use the 0.2 percent as a reasonable figure in our sample calculations in the preamble to the Proposed Federal Oil Rule.

3. Please provide a clarification of what we mean by "line fill."

We have enclosed a simple definition of the term "line fill" and the reference for how the allowance is calculated in the preamble to the proposed Federal Oil Rule.

4. Why does the "Summary of Costs and Royalty Impacts" chart in the preamble to the proposed Federal Oil Rule have ranges when the revenue impacts regarding the 2000 Federal Oil Rule did not?

We have enclosed information on the royalty impact analysis to the proposed Federal Oil Rule.

If you would like to discuss any of these issues further, please do not hesitate to call Lyn Herdt, Office of Congressional Affairs at (202) 208-3502.



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Form 6 - Annual Report of Oil Pipeline Companies Overview

The Form No. 6 is designed to collect financial and operational information from oil pipeline companies subject to the jurisdiction of the Commission.

The following is a list of important Commission Orders and/or decisions regarding the Form No. 6:

- Order 620 [eLibrary], issued December 13, 2000, requires all jurisdictional oil pipeline companies to use the Commission's software to electronically file Form 6 commencing with reporting year 2000, due on or before March 31, 2001;
- Order 606 [PDF, 38K], issued August 4, 1999, revises regulations governing oil pipelines. The regulations to be modified or deleted are located in 18 C.F.R. Parts 3, 341, 342, 343, 346, 357, 362, and 385. These revisions are intended to clarify the Commission's regulations and bring them up to date;
- Order 572 [PDF, 83K], issued October 28, 1994, amended regulations to adopt filing requirements and procedures with respect to an application by an oil pipeline for a determination that it lacks significant market power in which it proposes to charge market-based rates.

This rule adopts procedural rules in

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order to implement the Commission's Order No. 561 market-based ratemaking policy, which was published in the Federal Register on November 4, 1993. In that order, the Commission adopted a simplified and generally applicable ratemaking methodology for oil pipelines, which is an indexing system to establish ceilings on those rates.

The Commission also continued its policy of allowing an oil pipeline to attempt to show that it lacks significant market power in which it proposes to charge market-based rates. However, an oil pipeline may not charge market-based rates until the Commission concludes that the oil pipeline lacks significant market power in the relevant markets.

- o Order 561-A [PDF, 97K], issued July 28, 1994, amended regulations to revise the requirements for filing suspension supplements of oil pipeline tariffs in order to provide additional time to file suspension supplements; to modify the circumstances under which oil pipelines may use the cost-of-service methodology for changing rates in order to more closely track the standard for shipper protests to an indexed rate; and to modify the requirements to protests to oil pipeline tariff filings in order to require that a protestant file a verified statement to support its claim of a substantial interest in the proceeding.

The effects of these actions will be to provide more accurate, timely, and balanced approach to oil pipeline ratemaking under the Energy Policy Act of 1992 and the Interstate Commerce Act.

- o Order 561 [PDF, 192K], issued October 22, 1993, provides a simplified and generally applicable approach to changing just and reasonable oil pipeline rates. The simplified and generally applicable

approach, adopted in this final rule, for changing oil pipeline rates is an indexing system which will establish ceiling levels for such rates.

The Final Rule permits cost-of-service proceedings to establish just and reasonable rates, with regard to initial rates for new service, and also with regard to changes to existing rates where appropriate.

The Final Rule retains the Commission's current policy of encouraging settlements of rate issues at any stage.

The Final Rule does not disturb current Commission practice, which permits a pipeline to seek Commission authorization to charge market-based rates. However, until the Commission makes the finding that the pipeline does not exercise significant market power, the pipeline's rates cannot exceed the applicable index ceiling level or level justified by the pipeline's cost of service.

- o Opinion 154-B [PDF, 38K], issued June 28, 1985. On March 9, 1984, the United States Court of Appeals for the District of Columbia Circuit affirmed in part and remanded in part the Commission's opinion in Phase I of this proceeding.

The purpose in Phase I was to devise generic principles for the setting of just and reasonable oil pipeline rates. One essential ingredient in this task is to adopt rate base and rate of return methodologies which will operate together to produce a just and reasonable return allowance.

The Commission concluded that with the exception of the starting rate base, a rate base methodology derived from original cost rate making models should be adopted. As the court observed, original cost is a "proven alternative". As the Commission has observed, "the

language of American finance is an original cost language” for American industry reports its earnings on net book investment.

Hence, original cost is the best yardstick to compare an oil pipeline to other oil pipelines, to other industrial companies, to other industries, and to the entire American economy in order to approximate the oil pipeline’s cost of capital.

Therefore, the Commission adopted the Trended Original Cost (TOC) as the model for calculating rate based, and therefore, determining revenue requirements.

Updated: August 4, 2003

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About FERC

Office of Markets, Tariffs and Rates

What We Do

The Office of Market, Tariffs and Rates (OMTR) was created to integrate the Commission's economic regulation of the electric, natural gas, and oil industries. OMTR deals with matters involving markets, tariffs and rates relating to electric, natural gas, and oil pipeline facilities and services. The Commission is looking at how it can ensure lighter handed regulation for energy transactions in competitive markets, while standardizing terms and conditions for those transactions that will continue to be regulated on a cost basis.

Major areas of responsibilities:

1. Serves the public interest by providing leadership and vision in promoting just and reasonable market solutions to regulating economic activity in natural gas pipeline, oil pipeline and electric power markets.
2. Fosters the development of regional transmission organizations.
3. Provides the Chairman and other members of the Commission with policy options, recommendations and strategies relating to the Commission's regulation of the natural gas pipeline, electric power and oil pipeline industries. Prepares economic analyses of these industries with emphasis on assessing the significance of developments and trends for current and future regulatory policies.
4. Provides technical assistance and makes recommendations on proposals referred to the Commission by the Secretary of Energy, including major

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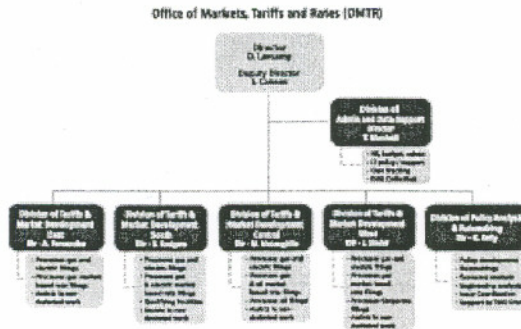
Allocation of Utilities to the OMTR Divisions:

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energy actions and rules proposed by DOE.

OMTR is led by Office Director Daniel L. Larcamp ([read biography](#)), and Deputy Director Shelton M. Cannon ([read biography](#)).

OMTR Organization Chart



Updated: August 4, 2003

Definition of “line fill” in regards to the Proposed Federal Oil Rule

Line fill: The volume of oil which is needed to be kept in the pipe of a gathering, transmission or distribution system to ensure the functioning of the system. See further explanation and example at 68 FR 50094.

Line Fill Clarification

50094

Federal Register / Vol. 68, No. 161 / Wednesday, August 20, 2003 / Proposed Rules

average of the returns to equity and debt (without considering income tax treatment). That led MMS to determine that two times the BBB rate was appropriate for that calculation.

MMS has examined some rates of return in the oil industry and believes that some weighted average rate of return considering both equity and debt is appropriate as an actual market-based cost of capital. MMS believes that establishing a uniform rate of return on which all parties can rely is preferable to the costs, delays, and uncertainty inherent in attempting to analyze appropriate project-specific or company-specific rates of return on investment.

MMS believes that the subset of companies that have invested, or are likely to invest, in oil pipelines is a very limited subset of the oil industry. MMS also believes that no standard industrial classification corresponds to those who are willing to invest in pipelines. MMS has received a new study from the American Petroleum Institute ("API"), titled "BBB Bond Rate Not an Adequate Measure of Capital Cost," that concluded that the cost of capital (after taxes) of the Department of Energy's Financial Reporting Service Companies was closer to 1.6 to 1.8 times the Standard and Poor's BBB bond rate. The API study explained that this group of producers included the companies that would be most likely to own pipelines. MMS, through its Offshore Minerals Management, Economics Division, has also studied several years' worth of data for both non-integrated oil transportation companies and larger oil producers, both integrated and independent, that MMS believes are more likely to invest in oil pipelines. This study concluded that that range of rates of return that would be appropriate for oil pipelines would be in the range of 1.1 to 1.5 times the Standard and Poor's BBB bond rate. While the relationship between the rates of return that MMS has examined and the BBB rate has not been constant, MMS is proposing for comment a rate of return of 1.5 times the Standard and Poor's BBB rate as this rate is within the range recommended by its own experts and close to the rate recommended by the industry experts.

2. Specification of Certain Allowable and Non-Allowable Costs—§§ 206.110 and 206.111

(i) Arm's-Length Transportation

In Section 206.110, MMS is proposing to add a new paragraph (b) that would specify many of the costs incurred for transporting oil under an arm's-length

contract that are allowable deductions. MMS believes these costs are costs that are directly related to the movement of crude oil to markets away from the lease. Those costs include:

(1) The amount that you pay under your arm's-length transportation contract or tariff.

(2) Fees paid (either in volume or in value) for actual or theoretical line losses.

(3) Fees paid to a pipeline owner for administration of a quality bank.

(4) The cost of carrying on your books as inventory a volume of oil that the pipeline operator requires you to maintain, and that you do maintain, in the line as line fill. You must calculate this cost as follows:

(i) Multiply the volume that the pipeline requires the shipper to maintain in the pipeline by the value of that volume for the current month calculated under section 206.102 or section 206.103, as applicable; and (ii) multiply the value calculated under paragraph (i) by the monthly rate of return, calculated by dividing the rate of return specified in section 206.111(i)(2) by 12.

MMS proposes to allow this deduction because this cost appears to be an actual cost directly associated with transporting oil. In each month for which line fill is required, a shipper incurs the loss of available capital associated with the value of the line fill volume. The proposal therefore would allow a return on that value, calculated as described above. MMS seeks comments on whether this cost should be allowed as part of the transportation deduction.

(5) Fees paid to a terminal operator for loading and unloading of crude oil into or from a vessel, vehicle, pipeline, or other conveyance.

(6) Fees paid for short-term storage (30 days or less) incidental to transportation as required by a transporter.

(7) Fees paid to pump oil to another carrier's system or vehicles as required under a tariff.

(8) Transfer fees paid to a hub operator associated with physical movement of crude oil through the hub when you do not sell the oil at the hub. These fees do not include title transfer fees.

MMS proposes to allow lessees to deduct transfer fees paid to a hub operator associated with physical movement of crude oil through the hub when the shipper does not sell the oil at the hub. MMS believes that this also is a cost directly incurred for movement of the oil. MMS believes that title

transfer fees are a cost of selling oil, not moving it, and are not deductible.

(9) Payments for a volumetric deduction to cover shrinkage when high-gravity petroleum (generally in excess of 51 degrees API) is mixed with lower-gravity crude oil for transportation. While this situation does not arise frequently, MMS believes that in such cases, this volumetric deduction is an actual cost incurred in moving oil.

(10) Costs of securing a letter of credit or other surety that the pipeline requires a shipper to maintain. These costs should only include the currently allocable costs applicable to the Federal lease. MMS believes that shippers can generally use two different means of assuring creditworthiness. The first involves a deposit or advanced payment in which the shipper incurs only the costs associated with the time value of money because they receive their deposit back. The other involves actual out-of-pocket costs to obtain a letter of credit, guarantee, or surety bond. MMS believes that these two means should be accounted for differently in calculating your transportation allowance.

In the first case, if you make a cash deposit of two months of the expected transportation charges (say \$50,000), and transport 100,000 barrels per month, of which 75,000 barrels are from a Federal lease, you must calculate the cost as follows:

(i) Multiply the deposit by the monthly rate of return, calculated by dividing the rate of return specified in section 206.111(i)(2) by 12, and (ii) multiply that result by the proportion of total production from each Federal lease. In this example, if the Standard and Poor's BBB bond rate was 8%, the allowable monthly rate would be

$$\left(\frac{.08 \times 1.5}{12} = .01 \right).$$

and that would be multiplied by the amount of the deposit to get the monthly cost, which would be \$500. Then you could include the share of that applicable to the Federal lease ($75,000/100,000 = 3/4$). So you could include \$375 as an allowable transportation cost for as long as the \$50,000 is on deposit (and the other factors remain unchanged).

In the second case involving the expense of a letter of credit or other surety, if you pay your bank \$5000 as a non-refundable fee for a letter of credit, you can include the proportion allocable to Federal production in the month that fee is paid, and then never again.

MMS believes that this is a cost that the lessee must incur to obtain the

ROYALTY IMPACT ANALYSIS OF AUGUST 20, 2003 PROPOSED FEDERAL OIL VALUATION RULE

In the August 20, 2003, proposed Federal oil valuation rule, MMS provided a summary of the estimated costs and royalty impacts of the proposed rule to all potentially affected groups: industry, State and local governments, and the Federal Government.

We estimated a royalty increase based on using NYMEX pricing for oil that is not sold at arm's-length and a royalty decrease for proposed additional allowable costs.

We further broke out the estimated royalty impact into three regions of the country because the June 2000 rule established different valuation methods for each region. For two of the three regions, the royalty impact estimates are shown in ranges rather than absolutes. Following is a summary explaining why we have included ranges in our royalty impact analysis.

Estimated Royalty Increase Based on Using NYMEX Pricing:

"Rest of the Country":

For the "rest of the country" the primary reason for the range is variance in the amount of oil that will be taken in kind. Our estimates ranged from a low of 50,000 barrels per day (small refiner program only) to a high of 180,000 barrels per day (small refiner plus Strategic Petroleum Reserve). If 50,000 barrels were taken in kind, the "in value" barrels affected by the proposed rule would represent 77% of total offshore production. If 180,000 barrels were taken in kind, the "in value" barrels affected by the proposed rule would represent only 19% of offshore production.

California and Alaska:

For California and Alaska, because the proposed rule uses new oil types and locations as its basis, to compare the royalty impact of using NYMEX instead of ANS, we had to make adjustments for quality and location to make a meaningful ("apples to apples") comparison. The ranges in our estimates are because of the variation in the quality and location adjustments that exist in the California market.

More specifically, there are significant differences in the quality (gravity and sulfur) of crude oil produced in California. For example, Kern River is 13.4 degrees API and ANS is 29.5 degrees API. In adjusting the prices at these locations to a common gravity, we used gravity adjustment scales that can vary from 15 to 25 cents per degree of API gravity. In making adjustments for location, we used tariffs that can range from between 75 cents and \$1.25 per barrel.

Rocky Mountain Region:

Neither of the situations that cause the estimates to include ranges for the “rest of the country” and for California/Alaska exist for the Rocky Mountain Region. While we do have an active royalty-in-kind program in Wyoming, the amount taken in kind has stayed relatively constant at about 4,000 barrels per day – an amount we did take into account in our estimates.

Royalty Decrease for Additional Allowable Costs:

For all three regions of the country, the reason for the ranges in our estimates of the royalty decrease for the proposed additional allowable costs is the fact that these costs can vary depending on the pipeline. For example, we estimate that the costs associated with line fill and with obtaining a letter of credit can both vary from between 2 and 5 cents per barrel.

For the “rest of country” the primary reason for the range is variance in the amount of oil that will be taken in kind as described above.